EXHIBIT B

Medi-Cal Policy Institute

The Medi-Cal Pharmacy Benefit

Medi-Cal's pharmacy benefit is the most frequently used Medi-Cal benefit and is the fastest growing portion of the Medi-Cal budget. Pharmacy coverage is particularly important to Medi-Cal beneficiaries with disabilities, mental illnesses, and chronic illnesses. It is also of critical importance to elderly Medi-Cal beneficiaries, many of whom are also enrolled in Medicare but must rely on Medi-Cal to pay for their pharmaceuticals.

How Does the Pharmacy Benefit Work?

Medi-Cal beneficiaries in fee-for-service (FFS) may visit any pharmacy that participates in Medi-Cal and present their Medi-Cal card and prescription to receive a drug (either prescription or over-the-counter). The Medi-Cal pharmacy benefit includes a list of contract drugs (formulary) that includes all major therapeutic categories of drugs and many over-the-counter (OTC) drugs. In order to prescribe a drug excluded from the formulary, a provider must obtain prior authorization from the California Department of Health Services.

Medi-Cal also restricts the FFS pharmacy benefit by imposing a cap of six prescriptions per month per beneficiary for most drugs and a copayment of $1 per prescription. Prior authorization must be obtained for coverage beyond the six-prescription limitation. The program also requires, when cost-effective, the substitution of generic drugs for the brand-name version unless the provider determines that a brand name drug would better meet the medical needs of the patient. In both Medi-Cal FFS and managed care, prospective and retrospective utilization review and a drug utilization review are required.

Medi-Cal managed care plans are required to cover all major therapeutic drug categories covered under FFS Medi-Cal; however, each plan establishes its own formulary and utilization review system. Typically, managed care plans also contract with particular pharmacies that members must use.

How Is the Benefit Paid for?

Funding for Medi-Cal's pharmacy benefit is determined through a complex combination of federal and state mechanisms with two main components: (1) Medi-Cal payment rates and (2) rebates that the federal government and California have negotiated with drug manufacturers.

Payment rates are based upon a formula of the estimated acquisition cost (EAC) and the fee paid to pharmacists to dispense the drug. Medi-Cal's EAC is the average wholesale price of a drug minus 5 percent. The dispensing fee is $4.05 per prescription. OTC drugs are reimbursed at 150 percent of the EAC. Since 1995, the state legislature has made several adjustments to the reimbursement formula, the net result being that all drug claims—prescription and OTC—are decreased by $0.25 each year.

The rates California pays for prescription drugs under Medi-Cal are offset in part by rebates the state receives directly from drug manufacturers. The state receives these rebates through two mechanisms. The first is a federal rebate system established in 1990 to increase the purchasing power of state Medicaid programs. This federal rebate program requires states to include a drug manufacturer's product on the state formulary if the manufacturer provides payments to states in the form of a rebate. Rebates are paid directly from manufacturers to states on a quarterly basis. The formula for the federal rebate program is the greater of either 15 percent of the average manufacturer's price of a drug or the difference between that price and the manufacturer's best price. OTC and generic drugs are eligible for more limited rebates. Drugs administered within Medi-Cal managed care plans, with the exception of County Organized Health Systems, are not eligible for the federal rebate program.

The second rebate mechanism functions through state contracts. California is one of two states that receive state supplemental rebates directly from

Medi-Cal Facts

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Highlights

- **Medi-Cal's pharmacy benefit is the most frequently used Medi-Cal benefit and is the fastest growing portion of the Medi-Cal budget.**
- **From FY 1997–98 to FY 2000–01, outpatient prescription drug expenditures in Medi-Cal increased by 55 percent.**
- **Pharmacy expenditures per beneficiary per month ranged from $18.97 for medically indigent children to $76.84 for medically needy blind or disabled adults.**

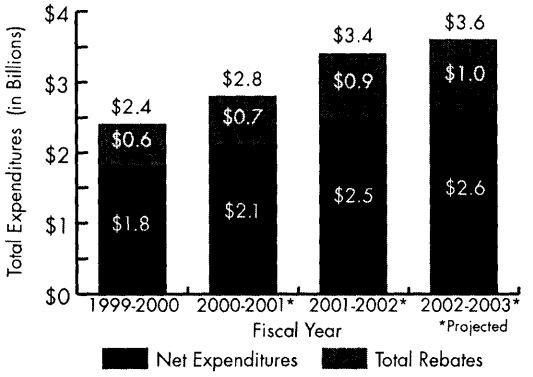
pharmaceutical manufacturers. Drug manufacturers must negotiate a supplemental rebate contract with the state to be included on the Medi-Cal formulary and a manufacturer's product must pass a review of its efficacy, safety, essential need, and potential for misuse.

In FY 1999–2000, California received $483 million in federal rebates and $158 million in state supplemental rebates, the equivalent of 37 percent of Medi-Cal's total FFS pharmacy expenditures. California is expected to receive nearly $1 billion in rebates in FY 2002–03.

How Much Does It Cost?

As in every state Medicaid program, California's prescription drug costs have been rising at an alarming rate. Nationally, Medicaid FFS outpatient prescription drug expenditures increased 66 percent between 1997 and 2000. From FY 1997–98 to FY 2000–01, outpatient prescription drug expenditures in Medi-Cal increased by 55 percent. This rapid rise in Medi-Cal FFS prescription drug costs is attributed to higher beneficiary utilization rates and greater costs per prescription. In 2001, the average cost per prescription was $66.40—up 33 percent from 1999. In 2001, the average annual pharmacy cost per Medi-Cal eligible was $1,114; however, the cost per beneficiary for those who actually used pharmacy services was $3,150.

Medi-Cal FFS Pharmacy Expenditures



Source: California Department of Health Services

Medi-Cal spending for pharmacy is projected to continue to increase for several reasons, including:

- Price increases for existing drugs;
- An aging population and an increased emphasis on preventive care will likely increase the volume of drugs purchased; and
- The development of new drugs for existing conditions will likely increase the volume and cost of drugs used.

Who Uses the Pharmacy Benefit?

All Medi-Cal beneficiaries have access to prescription drugs under Medi-Cal's pharmacy benefit. In CY 2001, an average of 933,338 (36 percent) fee-for-service Medi-Cal beneficiaries used this benefit every month. There is significant variation in pharmacy costs across categories of Medi-Cal beneficiaries. According to an analysis of FFS Medi-Cal pharmacy expenditures in Los Angeles from January 1997 through March 1999, expenditures per beneficiary increased most among aged, blind, and disabled beneficiaries. Much of the increase was attributable to cost increases for anti-psychotic medications. Pharmacy expenditures per beneficiary per month ranged from $18.97 for medically indigent children to $76.84 for medically needy blind or disabled adults.

What Issues Lie Ahead?

There are several pharmacy issues that require attention from policymakers in the near future, including:

- Are pharmacy cost-containment strategies used in the commercial sector, such as tiered copayments, appropriate for the Medi-Cal program?
- Can an increased emphasis on provider and enrollee education and disease management reduce Medi-Cal pharmacy expenditures?
- What opportunities exist to reduce payments or increase rebates without compromising patient care?
- How might the addition of a prescription drug benefit to Medicare impact pharmaceutical use and costs under Medi-Cal?

Changes to the pharmacy benefit will impact the Medi-Cal budget, sometimes in unintended ways, such as to increase spending for inpatient hospital care. Such changes also may impact the health and financial status of Medi-Cal beneficiaries, especially those who use the benefit the most: the elderly and beneficiaries with a disability, mental illness, or chronic illness. Consequently, it is essential for policymakers to weigh these issues carefully.